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SUBJECT: LOST IN TRANSLATION - IFIS CALLING FOR  
"UNBUNDLING" OF UKRAINE'S GAS TRANSMISSION SYSTEM

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¶1. (SBU) Summary. Econ Officers heard from Commissioner Ferrero-Waldner's Cabinet on March 4 that negotiations with Ukraine are ongoing over reforms requested by international financial institutions (IFIs) as a prerequisite for making investment commitments at the March 23 EU-sponsored investment conference for Ukraine's gas system. Specifically the IFIs are calling for Ukraine to unbundle its gas transmission system from control by state-run Nafhtogaz. Ukraine has strenuously objected to what they interpret as a requirement to privatize the system, but the Commission is working to explain that unbundling would not require privatization, but only a legal separation of the management and control over the system. End Summary.

¶2. (SBU) Emma Udwin, member of EU External Relations (RELEX) Commissioner Benita Ferrero-Waldner's Cabinet in charge of energy issues, told Econ Officers on March 4 that the Commission is still trying to work out arrangements with Ukraine for the March 23 EU-sponsored Ukraine Infrastructure Conference. Ukraine presented the Commission with a draft proposal of reforms last week. The Commission sent a revised version back to the Ukrainians and is awaiting their reply (acceptance), which the Commission has insisted upon by Friday, March 6.

¶3. (SBU) The key sticking point according to Udwin concerns unbundling Ukraine's gas transmission system -- along the lines of the requirements in the EU's Third Energy Package. Udwin emphasized that this is not an EU requirement, but a requirement put forth by the three international financial institutions (IFIs) who would be providing the investment funds to Ukraine. According to Udwin, the World Bank, the European Investment Bank (EIB), and the European Bank for Regional Development (EBRD) will not commit to providing loans to Ukraine without major reforms. The IFIs have said that they need transparency and clear legal status for the entities they would loan money to. Currently, with Nafthogaz, there is no transparency and the legal status of loans to Nafthogaz is unclear. Udwin asked "would, for example, IFIs be able to sue Nafthogaz in Ukrainian courts in the case of non-compliance?"

¶4. (SBU) Udwin believes that Ukraine misinterpreted the language in the original proposal from the IFIs, which called for the "corporatization" of Nafthogaz. The Ukrainians read "corporatization" as "privatization" and strongly objected to the concept of selling off the transmission system and the idea of the system falling in to private and/or third country hands and Ukraine has no desire to privatize its cash cow. Udwin said they are trying to get the Ukrainian side to understand the IFIs are not asking for privatization. The IFIs are asking essentially for the legal unbundling of the transportation system. The Ukrainian State could maintain

full ownership and control over the transmission system as long as they create a separate management structure (basically an independent system operator) to handle transmission that is independent of Nafhtogaz and that has a clear legal status under Ukrainian and EU law. Udwin stressed that the transmission system would remain Ukraine's sovereign property. After the meeting, a RELEX official said that, as part of the requirements for transparency, the Commission will also insist on metering at all the gas entry points from Russia.

¶5. (SBU) If Ukraine remains obstinate on the transmission system issue, Udwin said she will probably ask for USG assistance in clarifying the unbundling requirement to Ukraine officials. According to Udwin, if Ukraine cannot come to terms with IFIs reform requirements, the Commission sees no reason to proceed with the Conference. She said at this point they are proceeding in hopes of reaching an agreement, but confided "What's the point of having an investment conference if there is no one willing to invest?" Udwin said the EU understands the political challenges in Ukraine given the upcoming elections, but said "this is not about political gamesmanship;" the IFIs have demands which must be met.

¶6. (SBU) Udwin also asked for USG support in securing both Ukrainian President Yushenko's and Prime Minister Timoshenko's attendance at the conference. She said Yushenko and Timoshenko have been going back and forth and are creating a lot of confusion. (Note: Both plan to visit Brussels on March 19 to seek separate meetings with Barroso. End Note.) Udwin stressed the importance that both attend in order to demonstrate unified support for reform. Udwin said EU Member States are sitting on the fence waiting to see who commits before they commit to who they will send. If Yushenko and Timoshenko both attend, it is likely that EU President Barroso and Czech Prime Minister Topolanek will preside. She confirmed that Russian Energy Minister Schmatko and the new German Economic Minister Guttenberg plan to attend.

¶7. (SBU) Comment. We suspect that the nuances of the proposed reforms requested by the IFIs simply may have been lost in translation. It is ironic, however, that the EU is pushing Ukraine to move forward on unbundling its transmission system while it has been unable to come to an internal agreement on the unbundling requirements contained in the Third Energy Package. End Comment.

Murray

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